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TAX ALERT

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IRS issues proposed regulations for Section 956

Charles Edge | Partner, DHG Tax

On October 31, 2018, the Internal Revenue Service (IRS) and the U.S. Department of Treasury released proposed regulations under Section 956 of Internal Revenue Code 1986.

Sections 956 and 245A Background

Section 956 was enacted to create symmetry between the U.S. taxation of a CFC's actual dividend distributions and its investments in U.S. property (such as a loan to the U.S. shareholder) deemed to be substantially equivalent to a dividend. Accordingly, under Section 956, U.S. shareholders of a CFC that repatriated earnings into the U.S. through investment in U.S. property are treated as if they received an actual distribution of foreign earnings.

The Tax Cuts and Jobs Act (TCJA) created a participation exemption system under Section 245A that provides for a deduction for the foreign source portion of any dividend received by domestic corporations from specified 10 percent-owned foreign corporations.

The Proposed Regulations

Recently, the IRS and Treasury determined the Section 245A participation exemption creates inconsistences between the current broad applications of Section 956 to corporate U.S. shareholders and the intended purposes of Section 956. The proposed regulations would therefore exclude U.S. shareholders from the application of Section 956 to the degree required to keep symmetry between the taxation of actual repatriations and effective repatriations.

Specifically, under the proposed regulations, the following rules apply to U.S. shareholders of any CFC:

- A domestic corporate shareholder's share of an amount determined under Section 956 is reduced to the extent a deduction under Section 245A would apply if an actual dividend distribution was received.

- Non-corporate U.S. shareholders, including individual shareholders who make an election under Section 962 to be treated as a corporation for purposes of subpart F, will continue to be subject to Section 956.
- Regulated Investment Companies and Real Estate Investment Trusts will continue to be subject to Section 956.
- Corporate shareholders who do not meet the holding period requirements of Section 245A will remain subject to Section 956.
- Section 956 will continue to apply in situations where the deemed distribution of foreign earnings would result in a hybrid dividend. A hybrid dividend arises where the CFC receives a deduction or similar tax benefit with respect to its foreign tax.

Key Takeaways

For many U.S. corporate shareholders of a CFC, Section 956 will no longer result in the deemed repatriation of foreign earnings. The elimination of Section 956 could result in the restructuring of debt, and lenders may now require U.S. corporations to pledge up to 100 percent of the stock of a CFC as security for a debt.

Corporate shareholders eligible for the Section 245A deduction will no longer be able to intentionally trigger a 956 inclusion for purposes of generating excess foreign tax credits that could be used to offset U.S. tax on other foreign source income.

Non-corporate shareholders already burdened with especially punitive treatment under the GILTI provisions now have another reason to consider restructuring ownership of a CFC.

Effective Date

The proposed regulations will apply to taxable years of a CFC beginning on or after the date of publication of final regulations and to the tax years of a shareholder in which such taxable year ends for the CFC.

U.S. shareholders may elect to rely on the regulations for taxable years of a CFC beginning after December 31, 2017.

If you have any questions regarding Section 956 and the proposed regulations please contact your tax advisor.

Charles Edge | Partner, DHG Tax

tax@dhg.com